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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

SKELLY OIL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The findings of fact, conclusions of law and decision of the district court (R. 20-30)[1] are reported at 255 F.Supp. 228. The initial opinion of the court of appeals (App. A 1-10) and the majority (App. D 13-15) and dissenting (App. D 15-23) opinions on rehearing are reported in 392 F.2d 128.

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[1] "R." references are to the printed record in the court of appeals. "App." refers to the appendix to this petition.

JURISDICTION

The initial judgment of the court of appeals was entered on April 20, 1967 (App. B 11). The government's petition for rehearing was granted on June 27, 1967 (App. C 12). The judgment on rehearing was entered on April 3, 1968 (App. E 24-25). On July 2, 1968, Mr. Justice Brennan entered an order extending the time for filing a petition to and including July 9, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent, a producer of natural gas, in computing its taxable income for 1958, was entitled, as the court below held, to deduct the full amount of overcharges ($505,536) it refunded to customers in that year, or whether the deduction should be reduced, as the government contends, by 27½ percent or $139,022, representing depletion claimed and allowed as a deduction in computing taxable income in the prior years when respondent had included the $505,536 in its gross income.

STATUTE AND REGULATION INVOLVED

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in com-

puting taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the per-

centages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule.*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of

such item (or portion thereof) from gross income for such prior taxable year (or years).

* * * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341-1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

* * * *

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

* * * *

(26 C.F.R. 1.1341-1.)

STATEMENT

Respondent produces natural gas in Oklahoma (R. 14, 21; App. A 2). By order effective August 1, 1952, the Oklahoma Corporation Commission established a mandatory minimum price for sales of natural gas. In 1958, this Court ruled that the Oklahoma Commission was without jurisdiction. *Michigan Wisconsin Pipeline Co.* v. *Corporation Commission of Oklahoma*, 355 U.S. 425. On remand, the Oklahoma Supreme Court vacated the minimum price order. As the result of litigation, respondent, in 1958, refunded $500,000 to Cities Service Company and $5,536 to Dorchester Corporation, representing excess amounts collected from those two customers under the invalid minimum price order. (R. 14-17, 21-24; App. A 2-3).

Respondent had included those amounts in its gross income as received during the taxable years 1952 through 1957, since it then claimed an unrestricted right to them. In determining its taxable income for each of those prior years, respondent had claimed and the Commissioner of Internal Revenue had allowed percentage depletion with respect to such amounts, at the rate of 27½ percent, for a total of $139,022. (R. 23-25; App. A 3).

In its federal income tax return for 1958, respondent claimed a deduction in the amount of $505,536, the entire amount refunded. The Internal Revenue Service reduced the deduction by the $139,022 depletion allowed in the prior years. Respondent paid the resulting deficiency assessment and filed a claim for refund, which was not allowed. The instant suit for a

refund was then brought in the district court. (R. 25; App. A 3).[2]

The district court sustained the government's position (R. 29-30). The court of appeals, however, reversed, holding that Section 1341 of the Internal Revenue Code of 1954 entitled respondent to deduct the full $505,536 (App. A 1-10). After granting a rehearing, two members of the court of appeals panel adhered to the original decision, and one judge dissented (App. D 13-23).

REASONS FOR GRANTING THE WRIT

1. The decision of the court below is contrary to basic principles of tax accounting long established and recognized by decisions of this Court.

These go back to the fundamental concept of the annual accounting period, illustrated in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359. They were developed further in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424, where the Court held that a taxpayer who received money "under a claim of right and without restriction as to its disposition * * * has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." If repayment is required in a later year, the taxpayer may take a deduction under appropriate provisions of

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[2] The deficiency notice and refund proceedings raised other issues with respect to respondent's 1958 tax liability. These questions were resolved by stipulation in the trial court and are not in issue here. See R. 25-26.

the statute. The relevant provision is that for the deduction of a loss, and this does not authorize any greater deduction than the amount of the loss actually sustained. *Healy* v. *Commissioner*, 345 U.S. 278, 284 and n.17; see G.C.M. 16730, XV-1 Cum. Bull. 179 (1936).

In *Arrowsmith* v. *Commissioner*, 344 U.S. 6, this Court established the proposition that when a repayment is made, the tax consequences of the repayment depend upon the facts surrounding the original receipt. In that case, the taxpayer received sums in liquidation of a corporation which were taxable as a capital gain. Several years later the taxpayer had to make repayment of a portion of the sum he had received. Though there was clearly no "sale or exchange" in the later year, which is the usual earmark of a capital gain or loss, the Court held that these repayments were deductible only as a capital loss, since they arose out of and were a consequence of the prior capital transactions.

The repayment in this case was of money previously received from the production of natural gas; it was included in "the gross income from the property" which Section 613(a) makes the basis for the percentage depletion allowed upon the production of natural gas. The result was that in the years 1952 thru 1957 respondent had taken into net income only 72½ percent of the amounts received in those years and refunded in 1958. Under established rules, any 1958 loss deduction must take into account these antecedent facts, as *Arrowsmith* illustrates. Since the repayment arose directly out of the transactions which gave rise

to the percentage depletion deductions, this fact must be taken into account in determining the amount of the deduction for the loss actually sustained on the repayment.

Putting essentially the same proposition another way, the repayment might be analyzed by allowing a deduction for the full amount repaid, but requiring the restoration of the percentage depletion to income in the year of repayment, since, as events worked out, the respondent did not in fact have this amount as income from the production of gas. Though the earlier depletion deduction was correct when made, the eventual repayment established the fact that no percentage depletion deduction was in fact allowable. There was in fact, to this extent, no receipt from the production of gas, and under correct and established principles of tax accounting, the amount of percentage depletion previously deducted should be restored to income.[8]

It makes no difference which analysis is used, either a reduction of the deduction in the year of repayment, so as to limit the loss to the amount actually included in taxable income, or a deduction of the full repayment with an offsetting credit to income of the amount of the percentage depletion previously deducted, but now shown to have been unwarranted. The result is

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[8] It has long been established, for example, that where an accrual has been made, and deducted, for wages, the amount must be restored to income when it is later determined that the wages are unclaimed. *Chicago, R.I. & P. Railway Co.* v. *Commissioner*, 47 F.2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston and Western Carolina Railway Co.* v. *Burnet*, 50 F.2d 342 (C.A. D.C.).

the same. In either case the effective loss deduction is measured by the actual loss sustained.

The impropriety of the result reached by the court below can be illustrated by a parallel example. Suppose that a corporation received a dividend on shares of stock which it owned in another domestic corporation. Under section 61(a)(7) of the Internal Revenue Code, the amount of the dividend received would be includible in gross income. Under section 243(a)(1) of the Code, however, the corporation receiving the dividend is allowed a deduction in the amount of 85% of the dividend received. Thereafter, perhaps as a result of a suit by a minority shareholder, the receiving corporation may be required to repay the amount of the dividend to the paying corporation. Can it be supposed that it would be entitled to deduct the full amount repaid, without any adjustment for the 85% deduction for dividends received which it had taken in an earlier year? This would be carried to the ultimate extreme in the situation where there was a 100% deduction on receipt of the dividend, as is possible in some cases. See sections 243(a)(2) and (3) of the Code.

There can be no doubt that the analysis given above is sound, and that it is sustained by numerous decisions of this and other courts. Unless matters were somehow changed by section 1341, there can be no basis for the result reached below.

2. There is nothing in section 1341 of the Code which requires or warrants that it be interpreted as providing a loophole which would allow an aggregate

deduction in excess of that determined under sound accounting principles or under the previous law.

Section 1341 was first enacted in 1954. Under the previous law, it had been established that the adjustment for a repayment—whatever its character and amount—could be made only in the year of repayment. *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278. The effect of section 1341, where it applies, is to give the taxpayer another choice. He can (1) take a deduction in the year of repayment, as before, or (2) he can make an adjustment in the tax of that year by reducing it by the amount that his tax for the prior year was increased by the receipt. The first option is in section 1341(a)(4), and the second in section 1341(a)(5).

In the present case the adjustment for the prior year would clearly be in the amount of the tax resulting from the inclusion in income of the amount received *and* the deduction of 27½% of that amount as percentage depletion—that is, the tax on 72½ percent of the amount received which is the amount of tax respondent paid. The respondent is not interested in that. Instead, it relies on the other alternative provided by the statute, which is, in all essence, the same as that which was available before the statute was passed.

This is apparent when the text of section 1341 is examined. By its terms, section 1341 is applicable if three conditions are met. These are:

If—

(1) an item was included in gross income for a prior taxable year (or years) because it ap-

peared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000.

The second condition refers to "a deduction" which "is allowable." It does not say "a repayment," or "the amount which is repaid." The words are "a deduction." The statute applies "if a deduction is allowable * * * because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item."

This makes it necessary to determine what deduction would be allowable if section 1341 had not been enacted. It is only that deduction to which section 1341 relates; and this is the amount to which section 1341(a)(4) refers when it says that the tax shall be "the tax for the taxable year computed with such deduction". What is "such deduction"? Obviously this is "a deduction" referred to in section 1341(a)(2). This is not the "item" which "was included in gross income for a prior taxable year" under section 1341(a)(1), but is "a deduction" which results from the fact that it is later established "that the taxpayer did not have an unrestricted right to such item." Nothing in section 1341 specifies the amount of the "deduction," or qualifies or enlarges that amount in any way. That "deduction" must be determined under general

tax principles long established, and is not affected in any way by any of the provisions of section 1341.

This conclusion is supported by the pertinent Treasury Regulations. Section 1.1341-1(a)(1) of the Income Tax Regulations provides that: "If, during the taxable year, the taxpayer *is entitled under other provisions of chapter 1* * * * to a deduction * * *", he may claim one of the options provided in section 1341. (Emphasis supplied.) It is also confirmed by the fact that Section 1341 appears not in Subchapter B, where the deductions allowed in computing taxable income are set forth, but rather in Subchapter Q, which contains a variety of provisions best described by the subchapter title: "Readjustment of tax between years and special limitations."

The legislative history plainly indicates that the only purpose in enacting section 1341 was to provide an alternative to the rules of *Lewis* and *Healy*. There is no hint of an intent to sanction a new deduction clearly denied under prior law. The report of the Senate Committee on Finance states (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 118, 451):

> Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.
>
> * * * *

> If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

See also H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 86-87, A294-A295 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4113, 4436-4437).

The error of the court of appeals results from its confusion of the "item" referred to in section 1341(a)(1) with the "deduction" referred to in sections 1341(a)(2) and (4). Though these two terms are related, they are not necessarily the same, and the court below was wrong when it, in effect, held or assumed that the "deduction" was the same as the amount of the "item" repaid. With this error, the court of appeals opens up a wholly unintended and unnecessary loophole in the statute by reading its language "so broadly * * * as to defeat rather than further the purpose of Congress"—which, as this Court has said, cannot be justified. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52; *Burnet* v. *Harmel*, 287 U.S. 103, 108.

3. In practical effect, the respondent has been allowed two tax deductions of the same amount of

money. First, it took the 27½% depletion deduction when the customers' payments were received. Then it deducted the full amount of the repayment in 1958, including the entire amount previously allowed as depletion. It has long been established that such a double deduction of the same amount should not be allowed unless there is some statutory provision which clearly compels such a result. Thus, in *Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68, this Court said:

> If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. Cf. Burnet v. Aluminum Goods Co., 287 U.S. 544, 551. United States v. Ludey, 274 U.S. 295, 301. There is nothing in the Act that purports to authorize double deduction of losses or in the regulations to suggest that the commissioner construed any of its provisions to empower him to prescribe a regulation that would permit consolidated returns to be made on the basis now claimed by petitioner.

In granting the double deduction here involved, the court of appeals has so far departed from the accepted and usual course of judicial proceedings as to warrant this Court's intervention.

4. The decision of the court of appeals also is inconsistent with the rationale of *Douglas* v. *Commissioner*, 322 U.S. 275. In that case the taxpayer was allowed depletion on minimum royalties received in advance of production. The lease under which the royalties were paid was then cancelled without any production. This

Court approved the regulation (now Treas. Reg. § 1.612-3(b)(2)) which required that the depletion deductions previously taken be restored to income in the year in which the lease was cancelled.

The right to depletion rests on extraction of a mineral and the amount of the allowance is a percentage of the (Section 613(a)) "gross income" resulting from the extraction. Just as the depletion is restored to income when, as in *Douglas*, attempts at extraction are abandoned in a year after the income has been received and reported, see, *e.g.*, *Freeman* v. *Commissioner*, 48 T.C. 96, respondent should be required to make an adjustment for depletion taken in prior years since it later developed that part of the gross income—that which formed the basis for the depletion claimed—had to be refunded.

5. As a consequence of the broad sweep of federal, state and local regulation of the sales price of natural gas,[4] producers often collect and report for income tax purposes amounts later refunded to customers. The Federal Power Commission has advised the Commissioner of Internal Revenue, for example, that customer refunds approaching $95,000,000 are likely to result from two Commission rulings recently approved by this Court. (*Permian Basin Area Rate Cases*, Nos. 90, et al., Oct. 1967 Term, decided May 1, 1968, and *Federal Power Commission* v. *Sunray DX Oil Co.*, Nos. 60, et al., Oct. 1967 Term, decided

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[4] *E.g.*, *The Natural Gas Act* §§ 4, 5, 15 U.S.C. 717c, 717d; *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, See, generally, Federal Power Commission, Federal and State Commission Jurisdiction and Regulation—Electric, Gas, and Telephone Utilities (1967).

May 6, 1968. In other cases, the Federal Power Commission ordered nearly $90,000,000 in refunds in the three year period ending June 30, 1966. Potential refunds of comparable magnitude are at issue in cases still pending before the Commission. An additional large number of customer refunds are likely to result —as did the ones in this case—from the actions of state or local authorities.

The court of appeals has held that a natural gas producer which makes such a refund is entitled to claim total tax deductions of $1.275 for every dollar refunded to customers. In terms of tax liability, respondent pays less than it would have if it had never included the receipts in its income; having originally paid some $190,000 in taxes with respect to the overcharges, it has been granted a refund of $263,000 in a later year, even though tax rates and all other relevant principles of law remained the same throughout the period. Any producer in the same situation may achieve a comparable tax windfall.[5]

The inevitable consequence of the Tenth Circuit's ruling is uncertainty as to the tax liabilities of a large number of producers of natural gas. Because the depletion allowance is 27½ percent (26 U.S.C. 613(b)) and the usual tax rate is the corporate one in the vicinity of 50 percent, the amount of revenue at issue is in the tens of millions of dollars.[6] It is, moreover,

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[5] The refund ordered in the *Permian Basin case, supra*, alone may affect several hundred producers, see note 1, p. 1, of the dissenting opinion.

[6] Between $10,000,000 and $15,000,000 of taxes will be in issue simply as the result of the decision in *Permian Basin*,

essential that the proper tax rule be settled in order to avoid uncertainty in the normal course of rate regulation. An allowance for federal tax liability must be included in the cost of service of every producer. Cf. *Federal Power Commission* v. *United Gas Pipe Line Co.*, 386 U.S. 237. And, so long as the question here remains unsettled, that aspect of every natural gas rate-making proceeding must be attended by an equivalent degree of uncertainty.

There is, as yet, no conflict in decisions of the courts of appeals on the precise issue presented. But the one district court which has considered whether Section 1341(a)(2) in itself defines the "deduction" to which it refers, has sustained the rule of Regulation Section 1.1341-1(a)(1), *i.e.*, that the right to the deduction must rest on other code provisions. It has observed that any other interpretation would be "such a substantial departure from prior practice as to require at least some indication of this purpose in the legislative history of the section if not more precise language within the section itself." *National Life & Accident Ins. Co.* v. *United States*, 244 F. Supp. 135, 141 (M.D. Tenn.), affirmed on other issues, 385 F.2d 832 (C.A. 6). In addition, *O'Meara* v. *Commissioner*, 8 T.C. 622, the only pre-1954 Code case to consider the application of the "claim of right" rule to a depletion problem such as this case presents, held (8 T.C. at 634), as we contend here, "the amount of loss * * * must

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supra and *Sunray DX Oil Co., supra.* The Internal Revenue Service estimates the limitations periods have not yet expired for taxpayer's who are in a position to claim at least another $10,000,000 in refunds.

be limited by the net amount of * * * income reported for tax purposes after deducting for depletion."

The paucity of litigation is simply the result of the fact that taxpayers had not previously argued that Section 1341 should be read to allow a double deduction. If the question is now reviewed, and the governing legal principles set aright by this Court, the newly created uncertainty in the law can be readily resolved. Such a review will lay to rest the host of similar tax claims that have now been generated (see pp. 16-17 and n. 6, *supra*) and thereby avoid the stream of litigation that will otherwise result.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JULY, 1968.

APPENDIX A

Filed, United States Court of Appeals, Tenth Circuit, Apr 20, 1967, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—APRIL 1967 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

Appeal From The United States District Court For The Northern District of Oklahoma.

Robert J. Casey, New York City (Donald P. Moyers, Tulsa, Okla.; Of Counsel, Clark, Carr & Ellis, New York City, and Martin, Logan, Moyers, Martin & Conway, Tulsa, Okla., with him on the Brief), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant At-

torney General, Lee A. Jackson, Melva M. Graney, Loring W. Post, Attorneys, Department of Justice, Washington, D. C.; Of Counsel, John M. Imel, United States Attorney, and Lawrence A. McSoud, Assistant United States Attorney, Tulsa, Okla., with him on the Brief), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

The appellant brought this action for refund of income taxes on the ground that it was entitled in full to a deduction under Section 1341(a) (4) of the Internal Revenue Code of 1954, for refunds to corporations which purchased gas from it made following a price reduction.

The trial court reduced the claimed deduction by the amount of the percentage depletion deduction, and the taxpayer has taken this appeal.

The appellant has been in the business of producing and selling natural gas in Oklahoma for many years, and was so engaged during the period when a state minimum price order for natural gas sales at the wellhead was put into effect. This order raised the price of the gas appellant was selling under preexisting contracts, and continued in effect until it was declared invalid in Michigan Wisconsin Pipe Line Co. v. Corporation Commission of Oklahoma, 355 U.S. 425. After the order was terminated, a purchaser of

gas from appellant during the period the order was in effect brought a suit to recover from Skelly the difference between the contract rate and the price order rate. This suit was settled by the repayment by appellant to the purchaser of the sum of $500,000.00. Appellant paid another purchaser in a similar position the sum of $5,536.54.

The total of these two amounts was claimed and entered in its return as a deduction in 1958, the year it was paid. This was done pursuant to Section 1341 (a) (4) of the Code of 1954 in that it was established after the close of the prior taxable years that the taxpayer did not have an "unrestricted right" to such "an item" which was included in its gross income because it appeared it had such right for several prior taxable years, 1952 through 1957.

As indictated above, appellant claimed it was entitled to deduct the entire amount of the refunds. The trial court did not allow this amount, but instead reduced it by 27-½ per cent which was the percentage appellant had deducted in its returns for the years 1952-57 from its gas sales as depletion.

The statute (Section 1341 of the Internal Revenue Code of 1954) provides in part that:

"(a) General rule—If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that

the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3) the amount of such deduction exceeds $3,000,

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax . . . for the prior taxable year . . . which would result solely from the exclusion of such item . . . from gross income for such prior taxable year . . . ."

The parties stipulated in the trial court that appellant's taxes for the year 1958 are to be computed under the above subsection (a) (4).

As to the ground rules, it is apparent that the burden was on the appellant under these circumstances to establish a deduction. Corn Products Refining Co. v. Comm'r, 350 U.S. 46. Further as a general proposition a narrow construction is placed on statutory provisions for deductions. United States v. Olympic Radio & Television, Inc., 349 U.S. 232. The rules as to construction generally are contained in United States v. Allen, 293 F.2d 916 (10th Cir.), and in United States v. American Trucking Ass'ns, Inc., 310 U.S. 534.

The taxpayer argues on this appeal that the express wording of the section should be applied, and there are involved at least two separate and distinct tax events each fitting nicely into the statutory language. It also urges that the deduction dollars were without question paid out, and cannot be or should not be traced to their origin in a prior year.

On the other hand the Government argues that Congress could not have intended that such a benefit accrue to the taxpayer, that the several events are related, and one should be used to define the other.

The trial court concluded that the section was not clear, and resort should be had to its legislative history. Also it concluded that the policy of the legislation would not permit the result sought by the taxpayer, it being an unreasonable one. The court concluded that: "Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance. National and O'Meara, supra."

When the facts in the case at bar are set against the bare wording of the statute it appears that the requirements are satisfied to permit a deduction in the full amount. The "item" here considered was included in the "gross income" of the taxpayer during the several years prior to 1958, and it appeared that it had the unrestricted right thereto. Further "a deduction is allowable for the taxable year [1958]" because the facts show that after 1957 the taxpayer did

not have the unrestricted right to "a portion of such item," and the amount of the deduction is greater than $3,000.00. Thus the tax for 1958 would be computed with "such deduction." It is apparent that the term "gross income," "exclusion," and "deduction" used in the statute have well defined meanings. The parties stipulated that the $505,536.54 had all been included in the taxpayer's "gross income" for the years 1952-57. Thus if the wording is applied without more, the appellant is entitled to the entire deduction.

Before Section 1341 was enacted, a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned. The "claim of right" doctrine was firmly established by North American Oil Consol. v. Burnet, 286 U.S. 417. There was no alternative, however, if any remedy was sought as was held in both United States v. Lewis, 340 U.S. 590, and in Healy v. Comm'r, 345 U.S. 278. There thus existed the possibility that the taxpayer would be benefitted by the deduction over the treatment he would otherwise have received, or that he would be prejudiced. The result was then determined by a number of factors in the tax computation for the two or more years including the most obvious one—a change in tax rates. Thus the taxpayer in the pre-Section 1341 period was at the mercy of the circumstances with no choice given to him. The above cited cases establishing and refining the "claim of right" rule also reiterated the annual accounting doctrine and asserted it must be applied despite inequities which might arise from it.

For the present consideration it is sufficient to note that before Section 1341 a taxpayer by virtue of the permitted deduction could receive more benefit than the tax originally paid by him upon the "item" which had to be restored. Thus a benefit in the current year was recognized as a possibility, but not limited or related to the tax paid on the item in the previous year. It was then treated as any other deduction for these purposes in the year of restoration.

The change in "law" by the statutory enactment of Section 1341, considering the wording alone, was by the addition of the provision in subsection (a) (5) directed to those taxpayers who would suffer a disadvantage by the use of a current year deduction. This prejudice was removed by permitting the recomputation of taxes for the current year without the deduction and then a reduction of the tax so computed by the amount of tax attributable to the use of the restored amount in the earlier year if such a route would result in a lesser tax than would a current year deduction. The alternative recomputation provision appears in subsection (a) (5), and the current year deduction is recognized in (a) (4), as it existed before in a non-statutory form. It must be assumed that Congress had a real purpose in enacting the new remedy in (a) (5), and that it was to afford some needed relief in giving the taxpayer an alternative. There is nothing in the enactment itself to indicate an attempt to change the current year deduction remedy.

Thus it appears that Congress by Section 1341 enacted the existing rule as to current year deductions,

and added another and new provision whereby the taxpayer who qualifies can always receive a tax benefit from the deduction at least equal to the tax on the item when added to income, "and may receive a tax benefit of a greater amount." 2 Mertens, Law of Federal Income Taxation 340, ch. 12, § 12.106a (Zimet & Stanley Rev.). Thus it must be concluded that Congress sought to make no change in the current year deduction remedy, but only added the recomputation provision. The statutory enactment may have been precipitated by the strict application of the annual accounting rule in cases such as Healy v. Comm'r, 345 U.S. 278, 14 Oil & Gas Tax Quarterly 70.

The trial court found that the section was unclear or ambiguous, and resorted to the legislative history of the enactment of Section 1341. We do not decide whether or not the resort to the history was proper, or whether the wording is without such ambiguity. The legislative history leads to the same conclusion as does the examination of the preexisting state of the law and the statutory language described above.

The cases permit the examination of transactions taking place in prior years to identify or to characterize transactions in the current year. Arrowsmith v. Comm'r, 344 U.S. 6 (a pre-Section 1341 case), is an example. This may be done without violating the annual accounting principle, and a form of it appears in subsection (a) (5); however, we see no reason in the Act to reexamine the prior years' transactions in the case before us. The statute in subsection (a) (4), with which we are here concerned, does not require or indicate in any way that this be done.

The Government places great reliance on O'Meara v. Comm'r, 8 T.C. 622, 1947. There the taxpayer reported as income certain royalties received from oil production. He was later found by a court not to have title to the lease or land and had to repay the amounts received. This factor is an obvious distinction from the case at bar. There the question became whether the taxpayer was entitled to any deduction at all in the current year. See also Parr v. Scofield, 185 F.2d 535 (5th Cir.). The Tax Court in O'Meara held the taxpayer was entitled to a deduction in the current year of the amount repaid less the depletion allowance. The point with which we are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority.

To apply the rule sought by the Government would require the imposition of a limitation on the use of Section 1341(a) (4) determined by the amount of taxes paid by appellant in the prior years. There was no limitation or adjustment required in the doctrine expressed in (a) (4) before its enactment, and none is indicated in the statute. There appears to be no relationship established by Congress between (a) (4) and the prior year's computation other than those expressed in the Act, none of which are here pertinent. The Section only requires the tax for the current year to be figured "with such deduction."

There is no authority to permit a readjustment of the depletion allowance of the prior years nor may

later happenings alter it. Hugoton Production Co. v. United States, 349 F.2d 418 (Ct.Cl.).

Further there is no indictation that the source of the dollars used in the repayment was to be considered before Section 1341 (a) (4) nor thereafter, any more than the source of the dollars used for other deductions.

Much could be written on the subject of general policy about the result of this application of the statute without a judicial addition of conditions. This is however a specific, narrow statutory provision for a particular set of circumstances, and no broad general policy of Congress is indicated. The words used in the section have a clearly recognized meaning in the tax field, and the whole section is consistent when applied as its words direct. The refund problem and depletion was well recognized at the time of the statutory enactment.

The benefit which may accrue to the appellant is large, and thus it is different from previous instances where the benefit was small although well recognized; however, we see no reason to make a distinction based on the amount of money involved to override the statutory provisions. The trial court made no such distinction, but instead indicated that the general principles and the O'Meara case led to an addition of requirements not expressed in the statute. We cannot agree with this either, as the mandate of Congress is clear.

REVERSED.

APPENDIX B

TWENTY-FIFTH DAY, MARCH TERM, THURSDAY, APRIL 20th, 1967.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said district court in this cause be and the same is hereby reversed, and that this cause be and the same is hereby remanded to the said district court for further proceedings in accordance with the views expressed in the opinion of the court.

APPENDIX C

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges.

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

It is ordered that the petition for rehearing is granted and that this cause be set for re-argument July 13, 1967.

It is further ordered that the judgment of this court entered April 20, 1967, is vacated.

APPENDIX D

Filed, United States Court of Appeals, Tenth Circuit, April 3, 1968, William L. Whittaker, Clerk

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 8822—MARCH 1968 TERM

SKELLY OIL COMPANY, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

ON PETITION FOR REHEARING

Robert J. Casey, New York City (Thomas E. Tyre, John A. Craig, and Clark, Carr & Ellis, New York City, of Counsel, with him on Brief in Regard to Appellee's Petition for Rehearing), for Appellant.

Myron C. Baum, Attorney, Department of Justice, Washington, D.C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson, Loring W. Post, Attorneys, Department of Justice, Washington, D.C., with him on Petition for Rehearing), for Appellee.

Before MURRAH, Chief Judge, HILL and SETH, Circuit Judges.

SETH, Circuit Judge.

Opinion on Rehearing

The appellee filed a petition for rehearing which was granted. Additional briefs were submitted and oral argument was heard.

The parties, for better or worse, agreed during the litigation that 26 U.S.C. § 1341(a)(4) was the applicable provision. The case was tried on this basis and so presented to this court.

On rehearing, as well as on the original presentation, the Government urges that the case of O'Meara v. Comm'r, 8 T.C. 622 (1947), is determinative of the issue. The Government also urges that a construction of the section contrary to their position is not in accordance with the "spirit" of the legislation.

We are not prepared to rest this decision on the "spirit" of this portion of the statute. The rules of statutory construction are well established, and we are faced with a clearly worded section which refers to a very narrow point. This is not a provision referring to a matter of broad scope. Under these circumstances we must take it at face value.

The continued reliance by the Government on O'Meara v. Comm'r, 8 T.C. 622 (1947), is of little assistance, but it is understandable. It is obviously part of the pre-statute (1954) case law on this point, but if it did develop any new condition, such a condition was not carried over into the present section of the law. The matter of refunds of this character was well known when the statute was enacted, and we must assume that if Congress intended to create a condition as to the applicability of the section, it would have done so.

The O'Meara case does not purport to define "deductions" or anything else. This term, and the others here concerned, were defined by a myriad of cases where the issue was involved, both before and after O'Meara. Thus O'Meara was obviously part of the case law, but nothing it decided was incorporated in the statute nor influenced the construction of established tax terminology.

As stated in the original opinion, under these circumstances we cannot add a condition to the statute expressly or by a redefinition of terms, although we might wish to do so in view of the results. It is apparent that some remedial steps should be taken, but we cannot do so.

We adhere to our original opinion and dispostion of the case. REVERSED.

HILL, Circuit Judge, Dissenting.

This is a close and difficult case and one that has caused each member of the panel to burn some midnight oil. After the case was first submitted to us I agreed with my brothers that by a strict interpretation of 26 U.S.C. § 1341(a)(4) appellant was entitled to prevail and the opinion of the court was so written. Thereafter, and by a unanimous vote, a petition for rehearing was granted and the case was reargued. I then became convinced that our original decision was not correct and that the trial court should be affirmed. Therefore, I must now respectfully dissent.

I believe the trial judge was correct in reasoning that § 1341(a)(4) did not create a new deduction

and that thus the O'Meara decision [1] applied in the determination of the deduction allowable. The majority fails to present any reason for divorcing the determination of the deduction from its initiating basis.

The cornerstone of appellant's argument and the position apparently accepted by the majority is that "the statute utilizes interchangeably the phrase 'item included in gross income in prior year' with the term 'deduction.'" It is my contention that these two phrases are not used interchangeably and that a more reasonable interpretation of the statute is that the "deduction" to be allowed may in appropriate situations differ significantly from the item included in gross income. At no time does the majority define "deduction" as it is used in § 1341. It is, however, asserted that "deduction" has a well defined meaning. This can only refer to the meaning developed in pre-1341 cases dealing with the problem of refund of prior "claim of right" income. Indeed the majority recognizes that "the current year deduction is recognized in (a)(4) as it existed before in a non-statutory form." However, the majority's further statement that prior to the enactment of § 1341 "a taxpayer in appellant's position was permitted to deduct the amount of the item restored in the year it was so returned" without any reference to the O'Meara decision is misleading to say the least and is undoubtedly the crucial error in the majority's reasoning. O'Meara is bypassed by my distinguished brothers with the statement that "The point with which we

[1] Maurice P. O'Meara, 8 T. C. 622 (1947).

are here concerned is not developed in the opinion as the court does not indicate how the deduction for depletion should be applied. In any event the subsequent enactment of Section 1341 without stating any conditions or adjustments makes the cited case of doubtful authority."

To me it is much more reasonable to say that the existence of O'Meara in the case law pre-dating the enactment of § 1341 means that it must be considered as a part of the definition of "deduction" that arises from the case law. Certainly an examination of O'Meara shows that the court considered the problem of the effect of taking a prior depletion deduction on claim of right income which was later returned. The O'Meara case concerned a suit for refund of taxes which had been previously paid by O'Meara on royalties received from certain oil properties which had been acquired by O'Meara by warranty deed. During the years when such income was included O'Meara had taken the allowable depletion allowance on such royalties. Subsequently as a result of litigation O'Meara was held to have had unlawful possession of the mineral properties and was required to pay over all royalties received from such property. On his later return O'Meara deducted the amount so repaid and this deduction was disallowed by the Commissioner. The Tax Court reversed the Commissioner's rule and allowed the deduction,[2] limiting it and re-

[2] It is interesting to note that in 1341(a)(1) the term "an item included in gross income" is used as a requirement for the application of the statute. This same requirement was established in O'Meara, supra, to be the sole requirement

ducing it by the amount that O'Meara had previously taken as a depletion allowance.

Concerning the problem of reduction of the allowable deduction the court in O'Meara stated:

> "[T]he amount of loss for which petitioner is entitled to the deduction must be limited by the amount of the royalty income reported for tax purposes after deducting for depletion. It makes little difference whether the depletion deduction be viewed as a diminution of income, thereby resulting in effect in a reporting by petitioner of only the net amount of 72½% of the royalties received rather than 100%, or whether we recognize that the depletion deduction is permitted to one in the position of the owner of the oil in place or of a depletable interest therein, and that when it developed that petitioner was not the owner the deduction became erroneous, and petitioner is required to include the deducted amount as income in the year when that situation appears; see Douglas v. Commissioner, 322 U.S. 275; or whether the adjustment is viewed as required by the statutory definition of basis. Section 113(b)(1)(B), I.R.C. See Virginia Hotel Corp. v. Helvering, 319 U.S. 523. In any event, the net amount of the loss for which petitioner is entitled to take a deduction is the total of the royalties reported less the amount deducted for depletion." O'Meara, supra, at 634-5.

Appellant asserts that only the second of the above mentioned grounds for the reduction is valid; since

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for the establishment of a basis for later gains or losses. As discussed later there is, however, a significant difference between establishing a basis and allowing the full amount as a deduction.

in the instant case there was no question but that Skelly was at all times the legal owner of the land the O'Meara case is distinguishable and not applicable to the instant case. Apparently the court in O'Meara, however, felt that any of the above three mentioned grounds would be sufficient to uphold the government's argument that the deduction should be reduced by the amount of the depletion deduction previously taken.

I suggest that O'Meara stands for the basic principle that a basis established for gain or loss by the inclusion of income under a claim of right, which income has been the basis for a percentage depletion deduction, must be limited by that amount of the directly related deduction,[8] and that the reasoning and

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[8] A short analysis of the depletion deduction shows its direct relation to the gross income produced from a well and illustrates further why in recognizing a deduction for return of such income cognizance must be given the percentage depletion deduction.

A depletion deduction is allowed a taxpayer whose income results from production from a natural resource. In receiving such income the natural resource is depleted, thus depleting the taxpayer's capital investment. In computing other forms of income, i.e., such as a manufacturer's income, the capital investment of the manufacturer is considered and deducted. Thus in a similar sense a depletion deduction from income received from a natural resource is allowed as a return of the taxpayer's capital. 4 Mertens, § 24.02. Such depletion allowance was originally considered on two grounds, a cost depletion and a discovery depletion. Both of these depletion allowances had a specific limit upon the total amount of depletion that could be taken; however, these depletion limitations proved somewhat unsatisfactory as they made computation of the depletion difficult. Therefore, a percentage depletion deduction was established whereby the depletion de-

applicability of the O'Meara decision is just as applicable today as it was before the enactment of § 1341. I agree entirely with Judge Daugherty when he states "Any other procedure would do violence to the spirit of the legislation and the intent of the Congress to afford equitable relief to a taxpayer who thought he had a right to keep certain of his income and paid taxes thereon but it later turns out that he had no such right and was required to restore or repay the same. Congress intended that a taxpayer should get at least equal tax benefit but cannot have intended that a taxpayer should get a deduction allowable for income on which he had not previously paid a tax because of some benefit accruing to the specific income such as a depletion allowance." In fact any other position would appear to be totally unreasonable. The resulting effect would be that two measures intended to relieve and benefit the taxpayers can combine to result in a windfall to the taxpayer greatly exceeding the benefit which might result from the separate application of these measures. That such an overall result was intended seems unlikely.

It was argued by appellant that the statement of the court in O'Meara that "the process of establishing

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duction was made a direct function of the amount of income received from the natural resource. 4 Mertens, § 24.04. There is no limitation on the amount of depletion deductions which may be taken over a period of years such as with the cost of depletion or like the depreciation allowance allowed for the equipment used by a manufacturer. It is clear in fact that the total depletion deduction taken from a natural resource could far exceed the total cost of the natural resource. Commissioner v. Southwest Exploration Co., 350 U.S. 308.

a basis for an income item consists * * * of reporting it in the taxpayer's gross income * * *" Id. at 633, required that no further consideration be given to any depletion deduction taken from said income in the computation of the deduction allowable in the year of the repayment. The Tax Court in making this statement, however, was not considering the problem of the amount of deduction allowable but merely that the government did not have to receive any tax benefit from the inclusion of the income in the return in the prior year. The mere reporting of the item as gross income established a basis. The court, however, did not go on to say that the entire item included in gross income would establish the amount of the basis. This was not considered until the later portion of the opinion quoted above, where the court found that the deduction allowable was not equatable with the total amount included in gross income but was limited by the depletion deduction previously taken. No inconsistency results from saying that the inclusion of an item in gross income establishes a basis for later deductions notwithstanding lack of tax benefit to the government but not allowing a taxpayer to include the entire amount included in gross income as a basis for deduction.

Consideration of the percentage depletion deduction in determining the deduction allowable under § 1341 does not violate the annual accounting concept as established by Burnett v. Sanford & Brooks Co., 282 U.S. 359, as the consideration of the prior years' returns is only for the purpose of determining the amount of the allowable deduction in the present

year's return. There is no reopening or refiguring of prior years' taxes, merely a computation of the present year's taxes. That consideration of the prior years' returns may be made is clearly established by cases such as Arrowsmith v. Commissioner, 344 U.S. 6; Douglas v. Commissioner, 322 U.S. 275; and Dobson v. Commissioner, 320 U.S. 489. Cases cited by appellant such as Healy v. Commissioner, 345 U.S. 278, concern the taxpayer's proposition that the tax for the prior years be recomputed and that refunds be made from the taxes paid in the prior years. This situation is clearly not the one before us in the instant case. Here, as mentioned above, we are merely determining the amount of the allowable "deduction" in the present taxpaying year. The majority cites the case of Hugoton Production Co. v. United States, 349 F.2d 418, as authority for the proposition that consideration may not be given of the prior taxpayer years. The Hugoton case, however, is not direct authority for this proposition. That case involved the determination of the price received by similarly situated producers for purposes of establishing wellhead prices for depletion allowances. In the computation of such prices, the court stated that it could not consider refunds made by such other producers under situations similar to that of the instant case and gave as its reasons for not considering such refunds the annual accounting concept. The court went on to note, however, that such refunds would be reflected in any respect as they were considered in the subsequent years when the repayments were made. It should suffice for the Hugoton case to say that the

question considered by the court there was not the question which we are considering in the instant case. One could go on to question, however, whether the application of the annual accounting concept to the situation found in the Hugoton case required the result reached by that court. In any respect it is reasonable to say that consideration of prior depletion deductions allowed in computing a "deduction" allowable under § 1341(a)(4) for a current tax year is not a violation of the annual accounting concept.

In summary, the deduction for refunded claim of right income as originally established by case law and continued by § 1341 was to provide relief for a taxpayer from the application of the strict claim of right doctrine. It is unreasonable to transfer such relief into a windfall for the taxpayer unless such a result is clearly and unavoidably required. A double deduction should not be given unless there is virtually no alternative. Here I believe the more reasonable decision to be to limit appellant's allowable deduction by the amount of percentage depletion deduction previously claimed.

APPENDIX E

MARCH TERM, WEDNESDAY, APRIL 3rd, 1968.

Before Honorable Alfred P. Murrah, Chief Judge, and Honorable Delmas C. Hill and Honorable Oliver Seth, Circuit Judges

SKELLY OIL COMPANY, APPELLANT

8822 *vs.*

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court for the Northern District of Oklahoma.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel on January 10, 1967. On April 20, 1967, an opinion was filed reversing the judgment of the district court and remanding the cause to the said district court for further proceedings in accordance with the views expressed in the opinion of the court, and on that same date judgment in accordance with the opinion was entered. Thereafter on June 26, 1967, appellee's petition for rehearing was granted, the judgment of April 20, 1967, was vacated, and the cause was reargued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment entered on April 20, 1967, be and the same is hereby reinstated

and the judgment of the said district court is reversed and the cause remanded to the district court for further proceedings in accordance with the views expressed in the opinion of the court.

Honorable Delmas C. Hill, Circuit Judge, dissented.

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